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C O N F I D E N T I A L AIT TAIPEI 001638

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TAGS: ECON EFIN ETRD EINV PGOV PREL TW
SUBJECT: TAIWAN'S ECONOMIC OUTLOOK DARKENS, BUT FINANCIAL
SECTOR LOOKS SOUND

REF: TAIPEI 1630

Classified By: AIT Director Stephen M. Young for reasons 1.4 (b) and (d).

¶1. (C) SUMMARY. On November 20, official GDP figures showed the Taiwan economy contracted by 1.02% year-on-year (yoy) in the third quarter, a sharply lower figure than had been predicted just weeks earlier. The government's 2008 GDP growth forecast is now 1.87%, and the official estimate for 2009 GDP growth has declined to 2.12%, from 5.08% in August. Taiwan's increasingly gloomy economic outlook stems primarily from a decline in exports, which accounted for 73.7% of GDP in 2007. To help counter the slowdown, the administration on November 20 approved a plan to offer NT$ 3,600 (approximately US$ 108) consumption vouchers to all Taiwan citizens, a roughly US$ 2.5 billion program slated to add 0.64% to overall 2009 GDP growth. Despite weak exports and tightening credit, however, our financial sector contacts are confident Taiwan banks will weather the ongoing financial crisis and economic downturn. In general, our contacts do not expect the downturn to bottom out until the second quarter of 2009. END SUMMARY.

Economy shows fresh signs of weakness

¶2. (C) Over the past week, our contacts with financial sector officials, bank regulators, business executives, administration officials, and private economists have indicated growing pessimism about Taiwan's immediate economic prospects, tempered with underlying confidence in the viability of the financial system and faith in the economy's ability to ride out the global downturn, which most are predicting will last at least through the second quarter of
¶2009. The third quarter GDP figure, which showed a 1.02% year-on-year decline, was sharply at variance from predictions made only a few weeks ago by Premier Liu, who appeared to be expecting a figure in the 3-4% range.

¶3. (SBU) Even before the release of yesterday's GDP figures, however, there has been a widespread sense among many of our contacts that the Taiwan economy is decelerating more quickly than predicted only two months ago, when the global financial crisis first began to bite. At a November 18 lunch hosted by

the Director, and in other meetings, Taiwan bankers and economists acknowledged that collapsing domestic demand and falling exports, which posted an 8% year-on-year decline in October, are translating into real hardship for many of their customers.

¶4. (C) President Chen Tsu-pei of Cathay United Bank, the banking portion of Taiwan's largest financial holding company, told us he expects the Taiwan economy to deteriorate for at least another year. He said January would be particularly telling, because that is when Taiwan firms close for New Year celebrations and distribute annual bonuses. He said "good companies" would distribute small or even no bonuses, but a number of other companies would simply fold and not re-open. Chen also anticipated closures of Taiwan factories in China during this time. Faced with declining orders and rising costs, many are struggling, he said, particularly small and medium-sized enterprises. As the financial crisis continued, liquidity remains a problem for many of these firms. He noted that many SMEs have had their payment terms cut from 120-150 days to 90 days, which essentially dries up two months of liquidity. This causes a serious crimp in the cash flow for Taiwan firms, which often operate with razor-thin margins.

¶5. (C) Looking at larger firms, Chen said firms in all sectors are cutting investment and trying to find ways to lower labor costs. A number of firms, he noted, are putting workers on unpaid leave for two or three days a week. Other firms, he predicted, will close down for annual maintenance and the Chinese New Year holiday, but will delay reopening. Corning, the largest U.S. investor in Taiwan, told us it is shuttering its Taichung plant through early 2009 due to weak demand for its flat glass panels (reftel). The DRAM industry, in particular, is in trouble, faced with collapsing prices and falling demand. In the face of these deteriorating market conditions, Chen, and other bankers, noted that their banks were tightening credit for companies as well as for their credit card customers.

¶6. (C) Not all firms in Taiwan's vital technology sector are having serious problems, however. A senior executive at tech sector bellwether Taiwan Semiconductor Manufacturing Corporation (TSMC), for example, told us his company will be able to survive the downturn due to its strong cash reserves, despite a dramatic drop in orders from the U.S. At a recent luncheon hosted by the Director for young business entrepreneurs, participants representing the technology, design, bicycle manufacturing, consulting, and publishing sectors were all positive about their own business prospects, even if they were downbeat about the immediate fortunes of the overall economy.

Financial sector can weather the storm

¶7. (C) During the November 18 luncheon, a group of leading Taiwan bankers told the Director that, even in the face of the economic slowdown, Taiwan banks can easily weather the storm. Although they expect non-performing loans (NPLs) to increase and have noted some deterioration in consumer credit quality, their mortgage portfolios and large corporate loans are doing fine, except for some weakness in the SME sector. The bankers agreed that Taiwan's SMEs are especially vulnerable during the downturn. Until a few months ago, banks were counting on rising income from their rapidly-growing wealth management businesses, but this sector has largely collapsed in recent weeks.

¶8. (C) Yen Ching-Chang, Chairman of Yuanta Financial Holdings, said Taiwan's financial sector is in a much better position than a few years ago, in the wake of an overhang from excessive consumer credit. After an initial round of bank consolidation and injections of equity by the authorities, NPL ratios have dropped significantly. The banking system is flush with liquidity, noted Yen, although authorities recently had to step in and offer blanket deposit guarantees to stop the flow of funds from private banks,

which are perceived as riskier, to state-owned institutions. One bank officer told us that in September and October, over NT$150 billion (about US$4.5 billion) in deposits flowed out of private banks into the state-owned Bank of Taiwan.

¶9. (C) Separately, the Director General of the Banking Bureau, Chang Ming-dao, told us to expect a rise in NPLs and a fall in bank fee income, but that the exposure of Taiwan banks to the global financial crisis is much less that in other economies. The economic downturn, however is having an effect on Taiwan's real sector. For example, Taiwan's DRAM firms now have outstanding loans totaling around NT$ 250 billion (around US$ 7.5 billion). He believes the banking sector is strong enough to absorb any related losses in this and other weakening sectors, and predicts the Executive Yuan will craft a separate rescue plan to infuse liquidity into the troubled DRAM industry.

¶10. (C) Although the Director General of the Banking Bureau told us he expects financial sector reform to continue and that the Bureau will "encourage" banking sector consolidation, our private sector banking contacts are generally more pessimistic. State-owned or state-controlled banks still hold half of all assets in the market, and privatizing those institutions is politically sensitive due in part to strong opposition from unionized workforces. Victor Kung, President of Fubon Financial, observes that during the presidential election campaign, then-candidate Ma told the unions that no further privatization would happen during his administration. Public opinion, Kung added, does not necessarily support selling state-owned banks to private sector counterparts, many of which are controlled by wealthy families. In a separate conversation, however, SinoPac Holdings President Sean Chen told us the financial crisis will ultimately encourage mergers and financial sector consolidation as weaker players are forced out of the market.

Comment: No Panic

¶11. While the bankers and regulators that we spoke with expect tough times ahead, no one is showing signs of panic. Banks are prepared to deal with lower profits, but are not expecting to see significant deterioration of their balance sheets. The situation of Citibank, whose Taiwan head joined the Director's lunch, was telling. A few hours before, his New York headquarters announced massive job cuts, but he expected few if any redundancies in Taiwan. Banks aren't all that worried about their Taiwan operations.

SYOUNG